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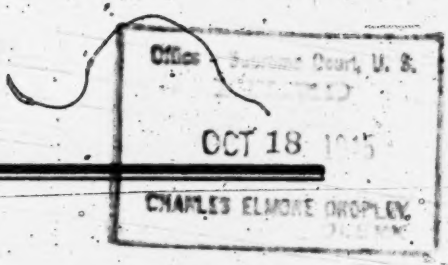

Supreme Court of the United States

OCTOBER TERM, 1945

No. 69

LILLIAN BOEHM,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S REPLY BRIEF

LOUIS BOEHM,
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I

Respondent argues (brief p. 18) that "a test conditioned by the state of mind of the individual taxpayer would present insuperable obstacles to tax administration". However, the subjective test for which we contend is not dependent solely upon the "state of mind" of the taxpayer. The subjective test depends not merely on what the taxpayer may think concerning the worthlessness of his stock, but rather upon what the taxpayer *does* in support of his opinion, particularly in attempting to make good his loss or to salvage his investment. In other words, the state of mind of the taxpayer is proven by his overt *acts* and *conduct*. No greater administrative difficulties should be encountered in determining the facts from

the circumstances of the taxpayer's conduct than would be encountered in determining when stock has become worthless from the numerous circumstances which usually lead up to a corporation's insolvency. Whether we apply the objective or subjective test, each of them requires an examination of the facts and circumstances surrounding a particular situation. The subjective test, we respectfully submit, is the fairer test, for it considers the circumstances in the light of what a reasonable man believes and does at the time and as the situation develops, whereas the so-called objective test looks at the situation only in the cold light of subsequent events.

This Court itself adopted the subjective test in *Lewellyn* v. *Electric Reduction Co.*, 275 U. S. 243. In that case it was held that a loss resulting from a buyer's prepayment to a seller, who proved to be irresponsible, was not sustained when the money was paid but was deductible in the future year at the termination of litigation, establishing the inability to recover the payment. At page 247, the Court stated:

> "There is nothing in the findings from which we could conclude that the respondent in 1918 had ceased to regard his rights under the contract as having value or that there was then reasonable ground to suppose that efforts to enforce them would be fruitless."

II

Respondent's observation (p. 25) that "neither the taxpayer nor the Government should be afforded opportunity to select the year in which deductions are taken" has no application here. In the present case, the taxpayer did not select the year in which to take her loss. The year was selected for her by the settlement of the Graham suit, which she did not control and in which she was only one of nine plaintiffs. It was beyond her power to determine the year in which the settlement should be made. Respondent does not claim that the settlement was

not *bona fide*. He does not claim that defendants, who paid out a very substantial sum of money, did it collusively to enable petitioner to take her tax loss in a year of her selection. Nor would it have been possible to do this, as the rights of eight other stockholders were involved, whose tax status was separate and necessarily different from that of petitioner. Respondent speaks of considerations of practical administration in support of his contention. We respectfully submit, however, that justice cannot yield to expedience. Expedience may be the basis of legislative policy, but is hardly part of the judicial process.

The case of *Lambert* v. *Commissioner*, cited by respondent (p. 18) does not support this theory of expedience. The Court merely held that worthlessness was "to be arrived at by practical considerations". We submit that an honest opinion of a taxpayer evidenced by affirmative conduct is a "practical consideration" which should enter into any determination of worthlessness. The case of *Bartlett* v. *Commissioner*, also cited by respondent (p. 18) in support of his theory of convenience of tax administration contains absolutely no reference to this contention as an element in the determination of worthless stock losses.

III

Respondent refers to the fact that in 1942 Congress amended the Revenue Act to make deduction of "debts which became worthless within the taxable year" retroactive to taxable years beginning after December 1, 1938. It can hardly be argued, however, that a legislative enactment passed in 1942 is proof of legislative intent in 1937, five years previously. If that had been the legislative intent then, no doubt Congress would have passed the amendment at that time. That it did not is proof that it was not the legislative intent at that time.

Respondent also refers to the fact that at the same time Congress enacted a seven-year statute of limitations with respect to refund claims relating to deductions both on account of worthless stock losses and bad debts in place of the former three-year statute. The enactment of this legislation, in our opinion, gives legislative recognition to the dilemma in which taxpayers frequently found themselves as to when a worthless stock loss should be taken, and gave relief to the taxpayer who had mistakenly selected the wrong year. That statute, however, was not in force in 1937. At that time, the three-year statute was in effect. The amendment therefore availed the petitioner nothing.

Apparently even the respondent was in doubt as to the year in which petitioner's loss should have been taken, for in the Court below respondent argued that Hartman was "hopelessly insolvent" in 1932, and that in 1933 there was "very little" value to the taxpayer's stock (brief below, p. 16). If Hartman was hopelessly insolvent in 1932, the loss should have been taken in that year. If there was still some value in its stock in 1933, as respondent also stated in the Court below, then the loss should not have been taken in 1932, but in a subsequent year when *all* value had departed. Just what that year is respondent does not state. However, when petitioner attempted to take her loss in 1934, he denied the deduction. But whether it was in 1932 or 1933, as respondent intimates, when petitioner obtained her recovery, in 1937, the statute of limitations had already run and she could have obtained no relief by applying for a refund.

IV

It would be quite difficult, from the record in this case, to determine when the loss on petitioner's stock should have been taken, had it not been taken in 1937. The

complaint in the equity receivership suit, commenced in 1932, specifically alleged that the assets then were greater than the liabilities and that stockholders had a substantial equity in the Company and that it was to preserve this equity that the receivership was being applied for (R. 33). In 1933, when the physical assets of the corporation's principal subsidiary were sold, the cause of action against the directors was not included in the sale and still remained as an asset of the Corporation. The amount involved in that suit was far in excess of creditor's claims. What the outcome of that suit would be could not have been determined in 1933, or at any time thereafter before the suit was either tried or settled. Consequently, had petitioner attempted to take the loss on her stock in 1932 respondent might very properly have disallowed it because at that time there was no proof that the liabilities of Hartman were greater than its assets. Had petitioner attempted to take the loss in 1933, the Commissioner might with equal propriety have disallowed it for the reason that there was then pending a suit for an amount greatly in excess of the claims of creditors and that until that suit had been determined, it could not be established that petitioner had sustained a loss, or the amount of the loss. It is true that in an effort to protect her rights, petitioner attempted to take the loss in 1934. The Commissioner disallowed the loss then. The suit was then still pending and there was nothing to indicate that petitioner would sustain a loss on her stock, or what the amount of the loss would be. Recognizing the validity of the respondent's position, petitioner acquiesced in the disallowance of her loss in that year. That petitioner's attempt to take the loss in 1934 was not due to any lack of confidence in her lawsuit is evidenced by the fact that, far from abandoning the same, she continued thereafter vigorously to prosecute the action and to spend substantial sums of money thereon.

V

Respondent claims (brief, pp. 29-30) that the equity receiver's reports of 1934 and 1935 established that Hartman was insolvent and its stock was then worthless. These reports made by the equity receivers show the amount of *cash* on hand and the liabilities outstanding. Respondent states "the only other asset listed in these two receiver's reports was the Graham suit for which 'apparently' no value was stated". The stipulation does not disclose whether or not the receivers placed a value on this suit (R. 21). Whether they did or not, however, is immaterial.

In the first place, assuming that no value was stated, it could hardly be expected that a receiver (Martin L. Straus) who was himself a principal defendant in the suit, and his lawyer and co-receiver, would or could honestly state the value of that suit. In the second place, it would have been impossible for them to place a value on the suit. That could only have been done after a trial of the issues on the merits and a determination by the court. Assuming that the receivers attempted to place no value on the Graham suit, this constitutes no proof of its worthlessness and respondent's contention that Hartman's assets consisted only of the cash in the hands of the receivers is wholly specious.

VI

Respondent points to the Tax Court's statement that it knew nothing of the merits of the Graham suit, the probability of recovery or the assurance of the collectibility of a judgment. In this we respectfully submit, the Tax Court erred. The facts concerning the Graham suit were set forth at length in the complaint. It appeared therefrom that the defendant directors had caused

the Corporation to purchase 64,879 shares of its junior stock at an aggregate cost of $1,422,000 or $22 per share; that at that time, the Corporation had cash of only $1,385,000, less than the amount spent in acquiring the stock; that it had current liabilities of over $5,000,000; that it was then operating at a loss; that the purchase of such junior stock was in no way essential for the conduct of its business, but, on the contrary, had seriously depleted its working capital and impaired its ability to carry on its business (R. 58). The complaint further alleged that part of the stock so purchased was owned by the defendant directors who personally profited from its sale to the Corporation. The complaint further alleged that the stock purchased at $22 per share was resold to the defendant officers and directors and to employees at $16 per share (a loss of $6 per share, more than 25% of the purchase price), *with the option to such officers, directors and employees to resell it to the Corporation at the same price,* which option was thereafter exercised and the Corporation compelled to repurchase the stock when its market value had drastically declined. The stock was retired by the Corporation when its market value had shrunk to $3 per share C 59 .

From the foregoing recital of facts upon which the Graham suit is based, it is apparent that the action was founded on substantial grounds and was in no sense a suit without apparent merit. We respectfully submit that all that need be shown in a tax controversy of this nature is that the action was brought in good faith and that it had some apparent merit. It is unnecessary and, of course, impractical to try out the merits of the action in a tax controversy with the Government. If that were required it would consume weeks and perhaps months of the Court's time to no good purpose. It is sufficient to show that the action was based on substantial grounds and that it was prosecuted in good faith. That was am-

ply shown in the present case by the facts set forth in the complaint, and the further fact that the petitioner and the other stockholders spent a substantial sum of money in prosecuting the action. That the cause of action had merit is further evidenced by the fact that the defendants paid to the complaining stockholders the sum of $50,000, a substantial sum, not in settlement of the cause of action of the Corporation (for the settlement could not dispose of that), but in settlement of the damage which petitioner and the other complaining stockholders individually had sustained by reason of defendants' acts. This settlement represented a payment of approximately $12 per share on the 4400 class A shares owned by the plaintiffs in the Graham case.

The Court below also stated that the stipulated fact that the defendants were men of financial responsibility does not establish the collectibility of the recovery against them in excess of the claims of creditors. The stipulation recites (R. 23):

> "That the defendant directors were persons of financial responsibility, some of them being members of the banking firm of Hallgarten and Company, investment bankers of New York and Chicago, one of them being president and director of the May Department Stores, and one being president, director and principal stockholder of The Advance Corporation which owned a majority of the stock of the Eversharp Pencil Company."

It is a matter of common knowledge that Hallgarten & Company are one of the leading investment banking houses in the country; that May Department Stores is one of the largest and most prosperous department store chains in the country, whose stock is listed and actively dealt in on the New York Stock Exchange; that the Eversharp Pencil Company is the highly prosperous manufacturer of the well known brand of "Eversharp" pencils.

These facts, taken in conjunction with the stipulated fact that the defendants were men of financial responsibility, is sufficient to raise a presumption that the defendants had sufficient means to respond to a judgment against them in this action in an amount sufficient to leave something for stockholders. The very fact that they paid out the large sum of $50,000 in settlement of merely the individual claims of those stockholders complaining in the Graham suit, despite the fact that there were large claims of creditors ahead of them, is sufficient evidence that there was merit to the action, and that they had sufficient means to respond to a very substantial judgment in favor of the Corporation. It is most unlikely that these men would have paid out $50,000 in settlement of an individual claim of stockholders unless a much larger sum could have been collected from them in the suit of the Corporation. Furthermore, the Tax Court interpreted the stipulation much too narrowly. The stipulation provided that defendants "were persons of financial responsibility." This means, of course, that they had sufficient means to respond to *all* claims against them. Among those claims was the claim of The Hartman Corporation for mismanagement and waste, a claim which was greatly in excess of the claims of creditors of Hartman. If they did not have sufficient means to respond to all claims against them, the defendants would not have been persons of financial responsibility—they would have been insolvent. That was the intention and meaning of the stipulation. If there was any doubt as to its meaning the Tax Court should have granted petitioner's motion to reopen the case for proof as to the precise financial worth of these defendants (R. 17).

VII

Respondent stresses that there should be an identifiable event which determines when stock becomes worthless. We agree. Such a test supports the petitioner's position.

As we have previously stated, the Commissioner himself was in doubt whether the identifiable event which he thought fixed the worthlessness of petitioner's stock, occurred in 1932 or 1933. On the other hand, the identifiable event which actually fixed the worthlessness of petitioner's stock undoubtedly occurred in 1937, when she settled her lawsuit, and released her rights against the Hartman directors. After that her stock had no further value. This is indeed a practical, definitive and certain event, and is quite in contrast to the Commissioner's doubt as to whether the identifiable event occurred in 1932, when the receivers were appointed, or in 1933, when the assets of Hartman's principal subsidiary were sold.

VIII

Respondent admits that "taxpayer's appraisal is one of the factors in the ultimate determination of value or lack of value in a given tax year, and where a going business is concerned and there is 'hope that a business although involved might be saved and value in the stock established' (*Forbes* v. *Commissioner*, 62 F. 2d 571, 574 (C. C. A. 4th) it may become a factor of importance." Respondent, however, argues that the doctrine does not apply because "here there is no going concern involved" (Resp. brief, p. 22). We fail, however, to see the distinction in principle between an involved and failing business in which hope still exists that some value might be saved for the stock and a situation, such as is presented here, where a pending cause of action involving a sum far in excess of creditors' claims is being vigorously prosecuted, for the purpose of ultimately saving some value for the plaintiffs' stock. If, as the Commissioner concedes (brief, p. 22) that the "*taxpayer's* appraisal is one of the factors to be considered in the ultimate determination of value" then certainly the petitioner's *bona fide* appraisal of the

merit and value of her cause of action, an appraisal which turned out not only to be reasonable but to be correct, should have been considered by the Court below and given effect. Instead both the Court below and the Tax Court wholly ignored the taxpayer's honest and correct appraisal.

IX

Respondent argues (brief, pp. 28-30) that there were a number of identifiable events which justified the Tax Court in finding that the stock had become worthless prior to 1937. In support of his contention respondent says that "Hartman admitted the allegations of the bill of complaint seeking to place it in receivership". Respondent fails, however, to mention that the complaint, the truth of which Hartman admitted, specifically alleged that its principal operating subsidiary then had assets "exclusive of goodwill, of approximately $9,500,000 and liabilities of approximately $4,600,000," leaving a net value for the stock of almost $5,000,000; and that Hartman's, Inc., another subsidiary, had assets of $1,086,000 and liabilities of only $55,000, leaving net assets of over $1,000,000 (R. 26-27), making a total of approximately $6,000,000 of net assets in two of its subsidiaries. Respondent also fails to mention that in the bill of complaint, which Hartman admitted to be true, it was alleged that its assets and properties and those of its subsidiaries, were of great value, which could not be quickly sold without great loss and that upon being administered through the equity receivership would be sufficient to pay in full all liabilities and leave a surplus for the stockholders (R. 33).

X

Respondent has not attempted to reply to Point II of our main brief in which we demonstrated that the decision

of the Tax Court on agreed facts constituted a determination of law, reviewable in this Court. Respondent has not attempted to distinguish the cases cited in support of this contention. However, in passing, the respondent cites two cases which he contends limit the scope of judicial review of a decision of the Tax Court where the case was submitted on an agreed statement of facts (resp. brief, p. 26). These two cases do not support the respondent's contention. Quite to the contrary, one of the cases is in petitioner's favor.

In the first case, *San Joaquin Brick Co.* v. *Commissioner*, 130 F. 2nd 220, the question presented was whether the taxpayer could deduct a worthless stock loss in a particular year. The case was submitted on an agreed statement of facts which failed to contain certain proof necessary to satisfy the taxpayer's burden. The decision of the Circuit Court of Appeals, upholding the Tax Court in disallowing the loss, was not based on any theory of limited review of the decision of the Tax Court. To the contrary, the Circuit Court analyzed the stipulation of facts and discussed the requisite proof which was deemed lacking. As stated by the Circuit Court at page 226, *supra*: "The value of these properties is not shown. No balance sheets of any kind are in the record." Thus the Court reviewed the facts contained in the stipulation and based its decision not on any theory of limited review but on the failure of the stipulation to contain facts necessary to satisfy taxpayer's burden. In the other case cited by respondent, *Commissioner* v. *Horseshoe Syndicate*, 110 F. 2nd 748, the sole question was whether a certain syndicate more nearly resembled a corporation than it did a partnership under the Revenue Act of 1932. The facts had been presented to the Tax Court by stipulation. The Circuit Court of Appeals as in the *San Joaquin Brick* case proceeded to review the stipulation and upheld the Tax Court's decision. As to the scope of judicial review where the decision below was

based on an agreed statement of fact, Circuit Judge Hutcheson in a concurring opinion, specifically upheld petitioner's contention stating at page 750, *supra;*

> "It is, I think, *a question of law,* that is in the sense that no other conclusion could be drawn from the undisputed facts than the one the Board drew." (Italics ours.)

Thus in both cases cited by the respondent the appellate court reviewed the undisputed facts because they presented for review a question of law.

XI

Respondent contends that the recoupment "does not represent a recovery in the Graham suit" (p. 35) because no money was paid to the corporation or to its creditors. There is no merit in respondent's contention. This argument was rejected by the Circuit Court of Appeals below when it modified the decision of the Tax Court in respect of the $12,500 received upon the settlement and stated (80):

> "Clearly whatever the petitioner received in settlement was paid her as a stockholder and represented damages for destruction of the value of her stock caused by the allegedly illegal acts of the defendants".

The reason that the payment was not made into the corporate treasury was because the Corporation's cause of action had not been compromised or settled. The payment was merely paid in settlement of the *individual* claims of the stockholders who had joined in the Graham suit. *In no way did it constitute a settlement of the cause of action of the Corporation itself,* nor did it prevent either the Corporation or other stockholders from prosecuting a similar action in behalf of the Corporation. That settlement of claims of individual stockholders is

permissible under the New York practice has frequently been held.

Cook on Corporations, Vol. 4 (8th ed. 1923), 3286;
Beadleston v. *Alley*, 55 Hun 606 (7 N. Y. Supp. 747), appeal dismissed 119 N. Y. 659;
Dresdner v. *Goldman Sachs Trading Corp.*, 240 App. Div. 242 (269 N. Y. Supp. 360), leave to appeal denied, 241 App. Div. 745 (270 N. Y. Supp. 961);
Manufacturers Mutual Fire Ins. Co. v. *Hopson*, 176 Misc. 220 (25 N. Y. Supp. (2nd) 502); aff'd 262 App. Div. 731 (29 N. Y. Supp. (2nd) 139), aff'd 288 N. Y. 668, 43 N. E. (2nd) 71.

In *Cook on Corporations*, Vol. 4 (8th ed. 1923) 3286, the rule is thus stated:

> "It is a principle of equity practice, when a person brings a suit in behalf of himself and such others as may wish to come in who are similarly situated, that the complaining stockholder controls the case and may continue, compromise, abandon, or discontinue it at his pleasure."

In *Beadleston* v. *Alley*, 55 Hun 606 (7 N. Y. Supp. 747), appeal dismissed 119 N. Y. 659, the Appellate Division, Second Department, stated the rule at 7 N. Y. Supp. pages 748-749:

> "This suit was in behalf of the plaintiff and other stockholders, but it was, nevertheless, her suit, and wholly subject to her control. * * * It is thus far plain that the plaintiff had the right to settle her own grievance against the parties who had done her the alleged wrong; and it was none of the other stockholder's business how or by what means she did it."

Quite recently the question was again raised in *Manufacturers Mutual Fire Ins. Co.* v. *Hopson*, 176 Misc. 220;

aff'd 262 App. Div. 731, aff'd 288 N. Y. 668, where Mr. Justice Shientag stated the rule as follows, at page 223:

> "But this court is bound by a line of cases in New York to the effect that a minority stockholder may discontinue his action at any time before another stockholder has intervened or judgment has been entered. The exclusive control of the action belongs to him and he can settle his individual damages, leaving other shareholders to seek their remedy in a new action."

XII

The respondent cites *United States* v. *White Dental Co.*, 274 U. S. 398; *Commissioner* v. *Brown*, 54 F. 2d 563; *Commissioner* v. *Highway Trailer Co.*, 72 F. 2d 913; *Commissioner* v. *John Thatcher & Son*, 76 F. 2d 900; *Niagara Share Corp.* v. *Commissioner*, 82 F. 2d 208; *Cahn* v. *Commissioner*, 92 F. 2d 674; and *Hinrichs* v. *Helvering*, 95 F. 2d 117 (p. 35) in support of his contention that a subsequent recovery does not establish that stock was not worthless in a prior year. These cases do not support the contention. In three of the cases (*Commissioner* v. *John Thatcher & Son*, *Commissioner* v. *Highway Trailer Co.* and *Hinrichs* v. *Helvering*, *supra*), there was no subsequent recovery. In the other four cases (*United States* v. *White Dental Co.*, *Commissioner* v. *Brown*, *Niagara Share Corp.* v. *Commissioner* and *Cahn* v. *Commissioner*, *supra*) there was a subsequent recovery but it was held that the *taxpayer* could elect to deduct the loss in the prior year and was not obliged to wait for the possible recovery. The case of *Niagara Share Corp.* v. *Commissioner*, cited by the respondent in this latter group, is discussed at page 33 of our main brief.

XIII

The concluding sentence in respondent's brief contains a footnote reference to the case of *Leiper* v. *Commissioner,* (1941-42 P-H B. T. A., Memorandum Decisions, par. 42, 211) which held that the Hartman class B stock had become worthless before 1937. The decision in the *Leiper* case, however, has no bearing on the decision in the instant case because (1) the basis on which the taxpayer in the *Leiper* case claimed her stock became worthless in 1937, differs from the basis on which the petitioner claims her stock became worthless in that year; (2) the evidence presented in the *Leiper* case differs materially from the facts stipulated in the case at bar; (3) certain evidence which the Court in the opinion in the *Leiper* case found was lacking is contained in the stipulation of facts submitted herein; (4) the *Leiper* case involved class B or junior stock of The Hartman Corporation, whereas the instant case involved class A stock; and (5) the petitioner in the *Leiper* case commenced no action against the directors but relied merely on another case to which she was not a party (not the Graham suit) which had been commenced but had been dismissed for lack of jurisdiction; and finally (6) Leiper recovered nothing on her stock.

The ruling of the Tax Court with respect to the worthlessness of stock of a company in a previous case has no bearing upon its decision in another case. Each case stands upon its own facts and upon the record presented to the Court. Due to the fact that the proof presented in each case differs from that presented in other cases, each decision must be based solely upon the record before it.

Mary S. Peabody, 38 B. T. A. 1086;
Rex E. Beach v. *Commissioner,* Docket #107408 (B. T. A.);

Morton L. Fearey, Docket #110614 (B. T. A.); *Julian M. Livingston*, 46 B. T. A. 538, 547.

In the case of *Mary S. Peabody*, 38 B. T. A. 1086, *supra*, the Commissioner disallowed a deduction of $31,156.15 as a loss on account of the worthlessness of the preferred and common stock of Middle West Utilities Co. The Commissioner claimed that this stock did not become completely worthless in 1932 and relied on a previous ruling of the Board of Tax Appeals that the stock had not become worthless in 1932. After reviewing the evidence presented before it, the Board of Tax Appeals concluded that the petitioner was entitled to take the deduction in 1932, since it held that the stock had become worthless in that year, declaring at page 1087:

> "The Commissioner now relies almost entirely upon the decision of the Board in the case of George H. Horning, 35 B. T. A. 897. Horning was there claiming a loss on common and preferred stock of the Middle West Utilities Co. on the ground that it became worthless in 1932. Thus the issue there was identical with the issue here. The headnote and the statement of the question in the opinion indicate that the petitioner failed for lack of proof. *Each case of this kind must be decided upon the evidence presented in that particular case.* All of the evidence introduced in the Horning case to show worthlessness in 1932 has been introduced here, *together with important additional evidence.*" (Italics ours.)

In the case of *Rex E. Beach*, Docket No. 107408, *supra*, the petitioner acquired certain common stock of the same Middlewest Utilities Co., prior to 1932, at a cost of $9,765.90. During the taxable year 1938 he sold the stock for $41.38, sustaining the loss of $9,724.52. Petitioner claimed a deduction of 50% on this loss under Section 23 of the Revenue Act of 1938. The Commissioner claimed that the common stock of the company became worthless in 1932, relying upon the decisions of the Board in the *Pea-*

body case, *supra*, and the case of *Benjamin and Julia F. Mahler*, Docket Nos. 88448 and 90482. The Board, nevertheless, held that upon the evidence presented to it in the *Beach* case, there was a continuing market for the stock from 1932 to the date of sale in 1938 and that the loss was properly taken in 1938.

Respectfully submitted,

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